



Economic Outlook

19 May 2014

The external environment of Lithuania's economy has deteriorated. With the conflict between Russia and Ukraine continuing unabated, the economic outlook for Russia and the countries with close economic ties to Russia is getting gloomier. Already last year, the growth of domestic demand faltered in Russia. Private consumption was the only expanding component on the domestic demand side as the growth of investment stalled amid structural problems and toned-down expectations. Economic growth in Russia is expected to decelerate further this year amid heightened risks of a deeper decline in economic activity in the context of persistent geopolitical tensions and increased uncertainty.

Still, the effects of weaker economic growth in Russia on economic activity in Lithuania are expected to be minor. Closer economic ties with Russia exist in the country's transport sector, which provides approximately LTL 3 billion litas worth of services to Russia's entities annually, and this accounts for a sizeable proportion of the total transport services provided in Lithuania. Unlike the transport sector, the dependence of Lithuania's industrial undertakings on changes in Russia's economic development is relatively low. Exports to this country comprise just a few percentage points of Lithuania's industrial output. Economic ties between the non-tradable sector and Russia are rather limited, too. Aside from travel services, which are provided on a somewhat larger scale, the supply of financial intermediation, information and other services to Russia's entities is negligible.

The weakening outlook for the Eastern European trade partners is partly offset by the recovering economic growth in EU Member States. Economic confidence indicators in the EU are improving and domestic demand is starting to rebound. Some favourable developments are also observed in the labour market. EU-bound exports of certain Lithuanian industries have started to increase after a certain period of stagnation. These favourable changes in economic development in the EU are not expected to be short-lived; therefore, Lithuania's exports to this region should keep growing steadily, thus supporting activity in the manufacturing industry. However, the outlook for total exports is now weaker than expected, to some extent, due to the deteriorating outlook for the growth of Russia's economy, but, most importantly, due to challenging conditions for petroleum product production, which has been falling much faster than expected, due to unfavourable environment in the global market for oil refining.

Economic growth is mostly driven by domestic demand. Although certain confidence indicators have worsened slightly, the effects of changes in the external environment on private consumption or investment can still hardly be seen. Retail trade and, simultaneously, private consumption are growing at a healthy pace supported by the increase in real labour income. Most likely, the growth of investment has slowed down, as compared to 2013, which, however, is in line with expectations. Hence, the outlook for domestic demand has basically remained unchanged thus far. Still, there are heightened risks that private consumption and investment spending will grow at a slower pace than currently expected. This expenditure may be constrained by increased uncertainty in the tradable sector, which may affect wage development, new hiring and investment in the sector's undertakings, as well as by potential deterioration in expectations of other businesses and households.

The worse-than-expected developments in Lithuania's exports and their weaker outlook have led to a more cautious assessment of the prospects of the growth of the entire economy. Real GDP is projected to increase by 3.3 per cent this year (compared to the previous forecast of 3.6%) and by another 3.6 per cent in 2015 (previous forecast — 3.8%). Although growth projections have been revised down, economic activity is expected to continue growing steadily. Domestic demand should continue its gradual expansion, driven by income developments. Net exports are projected to be weaker than expected, which, however, will not produce any substantial adverse effects on economic growth.

Inflation remains low and its forecasts are stable. The average annual inflation rate is expected to reach 0.9 per cent this year before increasing to 1.5 per cent next year. Trends in the developments of the prices, which are related to the situation in the global markets for commodities and which have made the biggest contribution to the decline in inflation, should remain favourable for consumers. International institutions expect the global prices of food commodities to decrease this year. In addition, crude oil future data suggest that the prices of this commodity will drop as well. As before, domestic demand is not expected to create any significant inflationary pressures in particular, as the GDP is now close to its potential level and its envisaged growth is close to the estimated

growth of potential GDP. The growth in unit labour costs, which picked up somewhat more in 2013 due to the increase in the minimum wage, should slow down considerably in the coming years; therefore, the rate of underlying inflation, as the component of inflation that is more dependent on domestic economic factors, will not grow substantially, either.

Outlook of Lithuania's economy in 2014–2015

	May 2014 projection			February 2014 projection		
	2013	2014*	2015*	2013*	2014*	2015*
Price and cost developments (annual percentage changes)						
Average annual inflation, as measured by the HICP	1.2	0.9	1.5	1.2	0.9	1.5
GDP deflator	1.7	1.1	1.3	1.6	1.1	1.3
Wages (compensation per employee)	5.0	3.6	4.3	4.8	3.5	4.1
Import deflator	-1.5	0.3	0.8	-1.5	0.1	0.8
Export deflator	-1.4	0.6	0.9	-1.4	0.5	1.0
Economic activity (constant prices; annual percentage changes)						
Gross domestic product	3.3	3.3	3.6	3.2	3.6	3.8
Private consumption expenditure	4.7	3.5	3.6	4.3	3.5	3.6
General government consumption expenditure	1.9	1.7	1.7	2.1	1.7	1.7
Gross fixed capital formation	12.8	6.6	7.6	12.3	6.7	7.7
Exports of goods and services	10.3	3.9	6.1	9.3	6.3	6.7
Imports of goods and services	10.3	5.2	7.0	9.4	7.2	7.4
Labour market						
Unemployment rate (annual average as a percentage of labour force)	11.8	10.4	9.2	11.8	10.4	9.2
Employment (annual percentage change)	1.3	1.1	1.0	1.3	1.1	1.0
External sector (as a percentage of GDP)						
Balance of goods and services	1.1	0.2	-0.4	0.9	0.4	0.0
Current account balance	1.5	0.0	-1.0	0.9	0.1	-0.6
Current and capital account balance	3.7	2.2	1.1	3.1	1.9	1.3

* Projection